

THE FEDERAL FINANCING BANK
AND THE BUDGETARY TREATMENT
OF FEDERAL CREDIT ACTIVITIES

The Congress of the United States
Congressional Budget Office

PREFACE

At the request of the House and Senate Budget Committees, the Congressional Budget Office (CBO) prepared this report on the Federal Financing Bank (FFB). The paper explains why the bank was established and what it does. It examines the problems created by the budgetary treatment of some of the FFB's transactions and alternative solutions to those problems.

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SUMMARY

THE FFB: DESCRIPTION AND ACTIVITIES

The Federal Financing Bank (FFB) is a unit of the Treasury Department whose function is to assist federal agencies in financing marketable agency-issued or agency-guaranteed securities. During the late 1960s and early 1970s, there was a dramatic increase in the number and volume of such securities offered in the government securities market by federal agencies or by borrowers with federal guarantees.

The proliferation of these agency-backed securities strained the capacity of the government securities market. Compared to the rates on the billions of dollars of securities regularly marketed by the Treasury Department, these newer securities--with their small size and unfamiliar provisions and terms--traded at wider spreads and higher interest rates. In addition, agencies and their guaranteed borrowers found it more expensive to finance their securities in the market because of the administrative costs of maintaining a financing staff or because of underwriting expenses.

Types of Securities

Three types of agency-backed securities were offered for sale: agency debt, certificates of beneficial ownership, and guaranteed securities.

Agency Debt. Agencies with authority from the Congress to borrow to finance their activities sold their own debt securities, in the same manner as the Treasury offers bonds, notes, and bills to finance the government's deficit.

Certificates of Beneficial Ownership. Federal agencies that made direct loans pooled a number of loans together and then sold certificates representing a share of ownership in that loan pool. These certificates of beneficial ownership (CBOs) could be sold in larger units than individual loans and were guaranteed by the selling agency. By selling CBOs, the lending agencies could refinance their loan portfolios, in effect generating new capital for further loans.

Guaranteed Securities. To allow nonfederal enterprises to tap the government securities market as a source of financing, some agencies fully guaranteed the repayment of interest and principal on securities issued by these enterprises. This approach evolved as the size of projects proposed for guaranteed financing grew larger, and as banks and other lending institutions became more hesitant to make long-term large commercial loans for these ventures.

Establishment and Growth of the FFB

To lower the borrowing costs of agency-issued and agency-guaranteed securities, the Federal Financing Bank was established in 1974 as a central financing authority for marketable federal securities (other than the Treasury's own borrowings). The bank was given the authority to borrow up to \$15 billion through the issuance of its own debt and unlimited authority to borrow from the Treasury.

Although it was originally expected that the bank would finance its activities through the issuance of its own debt, the Treasury officials who manage the FFB found it cheaper for the bank to borrow directly from the Treasury. The bank borrows at the Treasury's current rates; it lends to agencies and agency-guaranteed borrowers at the Treasury rate plus one-eighth of a percentage point. This is probably one-half a percentage point, or more, below the rate that agencies or guaranteed borrowers would have to pay if they offered their securities in the market, thus saving them millions of dollars annually in interest costs.

The demand for the favorable financing terms available through the FFB has grown rapidly since the bank's inception in 1974. Today, the FFB buys practically all debt issues and certificates of beneficial ownership offered by federal agencies. It also has become a major source of financing for the securities of guaranteed borrowers that otherwise would be sold in the government securities market. When the FFB purchases a guaranteed security, it is in effect making a direct loan to the security issuer. Initially, it was anticipated that the bank would lend \$6 to \$7 billion annually. During fiscal year 1975, its first full year of operation, it made new loans, net of repayments, totaling \$12.7 billion. After dropping to about \$9 billion in fiscal years 1976 and 1977, net lending by the FFB increased from \$12.7 billion in 1978 to \$24.8 billion in 1981. At the end of fiscal year 1981, outstanding loans by the FFB totaled \$107.3 billion.

Among the three categories of FFB financing, purchases of CBOs and other loan assets have predominated, accounting for 48.3 percent, or nearly half, of the bank's outstanding holdings at the close of fiscal year 1981 (see the Summary Table). The Farmers Home Administration (FmHA) has been the principal seller of CBOs to the FFB. In 1981, \$48.8 billion of CBOs sold by FmHA accounted for 94 percent of the bank's loan asset holdings, and over 45 percent of all FFB holdings.

Direct loans to guaranteed borrowers accounted for nearly 29 percent of the FFB's total holdings at the end of fiscal year 1981. Rural electric cooperatives, with guarantees from the Rural Electrification Administration (REA), and foreign governments, with guarantees from the Department of Defense (DoD), constituted the largest groups of borrowers in this category in terms of the dollar volume of loans made. Outstanding direct loans by FFB to these two groups totaled \$21.4 billion by the end of 1981, or 20 percent of total FFB holdings. Holdings of outstanding agency debt accounted for the remaining 23 percent of the FFB's portfolio, with the Export-Import Bank and the Tennessee Valley Authority (TVA) taking the lion's share (\$23.3 billion, or 94 percent of all debt holdings).

BUDGETARY PROBLEMS AND CONSEQUENCES OF FFB ACTIVITIES

Problems

Although the FFB has been a success as a debt management and financing tool, its purchases of CBOs and its direct loans to guaranteed borrowers pose two budgetary problems. First, the direct loans represented by these two transactions are counted neither in the initiating agencies' budgets nor in the unified budget totals. Instead, they appear in the off-budget FFB's budget. Consequently, agency budget totals and the budget deficit are understated by the amount of CBO sales to the FFB and FFB direct loans to guaranteed borrowers. ^{1/} This advantageous

^{1/} The unified budget totals and deficit are also understated by the activities of the other off-budget entities: the Rural Electrification and Telephone Revolving and Rural Telephone Bank of REA, the Postal Service, the Regional Rail Reorganization Program of the U.S. Railway Association, and the Synthetic Fuels Corporation.

SUMMARY TABLE. FFB OUTSTANDING HOLDINGS, BY TYPE OF ACTIVITY (End of fiscal year, in billions of dollars)

Activity	1980	1981
Agency Debt		
Export-Import Bank	10.1	12.4
Tennessee Valley Authority	8.9	10.9
Other	<u>2.1</u>	<u>1.6</u>
Subtotal, Agency Debt	21.1	24.9
Loan Assets <u>a/</u>		
Farmers Home Administration	38.0	48.8
Rural Electrification Administration	1.9	2.6
Other	<u>0.5</u>	<u>0.4</u>
Subtotal, Loan Assets	40.4	51.8
Direct Loans to Guaranteed Borrowers		
REA guaranteed loans to rural electric cooperatives	8.4	12.3
DoD guaranteed loans for foreign military sales	7.2	9.1
Other	<u>5.9</u>	<u>9.2</u>
Subtotal, Direct Loans to Guaranteed Borrowers	<u>21.5</u>	<u>30.6</u>
Total, FFB Outstanding Holdings	83.0	107.3

SOURCES: Budget of the United States Government, Fiscal Year 1982, Special Analysis on Credit; and Department of the Treasury, Federal Financing Bank News, September 1981 Report (October 26, 1981).

a/ Primarily certificates of beneficial ownership.

budgetary treatment creates a second problem: the possibility that resources may be overallocated to activities financed through the FFB.

CBO Sales: Transferring Direct Loans Off-Budget. The sales of certificates of beneficial ownership by FmHA and REA to the FFB are treated in the budget as loan asset sales, notwithstanding the fact that they are not really asset sales. Special provisions of law require this treatment, although it is contrary to established budgetary principles.

In an outright loan asset sale, an agency sells a loan or group of loans to an investor, transferring possession of the loan note or instruments to the new owner. The investor assumes the risk of default and the responsibilities for servicing the loan. Because the outright sale of a loan asset results in the agency recovering its loan capital and being relieved of any risk, such a sale is recorded in the budget in the same way as a loan repayment--as a negative outlay or offsetting receipt--thus reducing the agency's or program's outlay total.

A CBO sale differs from a true asset sale in several respects. First, the agency retains possession of the loan instruments; all it sells is a security representing ownership in a pool of loans. Second, the agency retains responsibility for servicing the loans; it collects interest and principal payments and then pays these to the CBO purchaser. Finally, the agency retains all the risk; it guarantees in full timely payment of interest and principal on the certificate. In reality, an agency selling a CBO is borrowing from the CBO purchaser.

By treating CBO sales as asset sales, an agency, such as FmHA, is able effectively to transfer outlays off-budget to the FFB. By selling loans to the FFB in the form of CBOs, FmHA is able to offset the outlays for the loans with the receipts of the CBO sales. Thus, FmHA could make \$5 billion of loans in a fiscal year, sell a \$5 billion CBO to the FFB, and have an outlay total of zero for the year. The FFB, however, would record outlays of \$5 billion for the CBO purchase. The practical effect is merely that of transferring an on-budget loan to off-budget status. The loans do not disappear, however, by virtue of being removed from the unified budget. They merely become part of the off-budget deficit, which itself must be financed by Treasury borrowing (the FFB's borrowing to purchase the FmHA's CBO, for example).

If, however, FmHA sales of CBOs were treated as borrowing by FmHA to finance its direct loans, as recommended by the 1967 President's Commission on Budget Concepts, the effects on the FmHA budget, and unified budget as a whole, would be dramatic. FmHA could not reduce its outlay totals; instead, its budget would show the full amount of its net lending each year. For instance, FmHA reported outlays in 1980 of \$3.0 billion. Not included in that figure, however, were net new loans of \$6.9 billion financed through CBO sales to the FFB. If these sales had been treated as FmHA borrowing, its outlays would have more than tripled, to \$9.9 billion.

In the case of FmHA and REA CBO sales to the FFB, the problem is not really the FFB; it is the special legislative provisions that allow these two agencies to treat CBO sales as asset sales although they should be treated as borrowing. In the absence of the FFB, the transfer of direct loans off-budget would continue. Instead, however, of the loans being transferred to the visible, albeit off-budget FFB, they would be transferred to a nonfederal investor and truly become invisible. And FmHA would pay more in interest costs as well.

FFB Direct Loans to Guaranteed Borrowers: Originating Loans Off-Budget. When the FFB purchases a security or underwrites an entire issue of securities issued by a nonfederal enterprise with a federal agency guarantee, it is in effect making a direct federal loan to that enterprise. The loan is recorded off-budget, and is not charged to the agency that guaranteed the securities in the first place.

The transfer of loans off-budget that occurs when FmHA and REA sell CBOs to the FFB results from the violation of a budgetary principle. The origination of direct loans to guaranteed borrowers off-budget is consistent with the budgetary principles governing loan guarantees, however. The problem in this case is the off-budget status of the FFB. If the FFB were put on-budget, then FFB direct loans to guaranteed borrowers would be included in the unified budget totals, but they still would not be charged to the originating agency's budget.

In actuality, however, the fundamental problem is in the inadequacies of existing budget concepts to deal with credit transactions that are in the "grey area" between direct federal loans and loan guarantees. A federally guaranteed security that, before the FFB's establishment, would have been sold in the government securities market has practically the same characteristics as a

direct loan by a federal agency to a nonfederal enterprise, financed by the agency borrowing with its own debt issuances. The treatment of the two transactions is quite different, however. The guarantee transaction does not affect the agency's outlay total or the unified budget deficit. If, instead of guaranteeing the loan, the agency made a direct loan financed by borrowing, its outlay total and the unified budget's total outlays and deficit would both be increased by the amount of the loan.

Consequences

Because both CBO sales, whether financed by the FFB or not, and FFB direct loans to guaranteed borrowers transfer direct loans off-budget, they cause total budget outlays and the unified budget deficit to be understated, as explained at the beginning of this section. This was amply demonstrated in fiscal year 1981 when the FFB's purchases of \$11.5 billion of CBOs and its direct loans of \$9.4 billion to guaranteed borrowers caused total outlays and the deficit to be understated by \$21.0 billion. The reported 1981 deficit of \$57.9 billion was in fact 26.6 percent below the level of a combined unified budget deficit and FFB deficit. This treatment undermines the utility of the budget deficit as a measure of the amount of federal activity that requires financing by borrowing.

Moreover, FFB-financed CBO sales and direct loans to guaranteed borrowers frustrate the setting of priorities among competing programs in the budget process, because they permit agencies to undertake activities that are never charged to them, and that never show up in their budgets. In fact, the ability of agencies to finance activity "invisibly" through the FFB raises the possibility that resources may be overallocated to such activities, because of their apparent, although not real, "costlessness." One has only to look at the examples of FmHA and REA, the FFB's two biggest clients, for evidence that this may be occurring. It took from fiscal year 1951 until 1974 for the annual level of new direct loans by FmHA to climb from \$128 million to \$3.9 billion. In the next six years, that level increased from \$5.6 billion in fiscal year 1975 to \$15.8 billion in 1980. Similarly, the annual level of new loans by REA grew from \$268 million in fiscal year 1951 to \$802 million in 1974, but jumped in fiscal year 1975 to \$1.1 billion, and reached \$3.7 billion by 1980.

These two problems (understatement of the deficit and mis-allocation of resources) result from the budgetary treatment of CBO

sales and the off-budget status of the FFB. The existence, however, of the FFB as a source of apparently limitless credit at rates only slightly above Treasury's borrowing costs has no doubt played a part, particularly with the explosion of FmHA and REA lending levels in the FFB era.

ADDRESSING THE PROBLEMS POSED BY THE FFB

As awareness of the problems posed by FFB financing of CBOs and direct loans to guaranteed borrowers has increased in recent years, various proposals have been advanced to address these problems. Some proposals focus on the FFB itself. Others address the underlying issue: the budgetary treatment of CBO sales and direct loans to guaranteed borrowers. One final proposal would resolve the problems posed by FFB financing as part of a general restructuring of the unified and credit budgets.

Three criteria should be used to evaluate the proposals to change the FFB and its activities. First, the proposed change should improve the utility of the budget deficit as a measure of federal borrowing requirements. Second, it should improve the process of allocating resources through the budget process. And third, the proposal should ensure that the gains in financing efficiency achieved through the FFB are not lost.

Changing the FFB Itself

Abolishing the FFB. Some observers think that the problems resulting from the FFB as a source of off-budget financing could be resolved simply by abolishing the bank. This proposal would effectively restore the situation that existed prior to 1974, before the bank's establishment. It would, therefore, lose all the gains in FFB financing efficiency as agencies returned to selling CBOs and guaranteed securities in the government securities market. Because it would not change the underlying budgetary treatment of CBO sales or remedy the inconsistency in the treatment of fully guaranteed securities sold in the market, this option would not improve the process of allocating resources in the budget process nor would it reduce the understatement of total federal lending, and thus of total outlays and the deficit.

Putting the FFB On-Budget. H.R. 2566, the Federal Financing Bank Act Amendments of 1981, would repeal the statutory exclusion of the FFB from the unified budget; would require appropriation

act approval of the total amount of FFB activity for any fiscal year; and, in order for a guarantee to be effective, would require that the FFB purchase federally guaranteed securities rather than allow agencies to sell them in the government securities market. The effects of these provisions would be to:

- o Include the budget authority and outlays for FFB purchases of CBOs and FFB direct loans to guaranteed borrowers in the unified budget totals and deficit;
- o Set a ceiling on total FFB activity. In the absence, however, of Congressional decisions on which of the FFB's clients should get financing and how much, a race would develop among agencies to get to the FFB "window" before the allotment for the year was exhausted; and
- o Prevent agencies from undermining the FFB ceiling by returning to the market to sell CBOs or finance fully guaranteed securities, since such securities would have to be bought by the FFB for the guarantee to be effective.

By including FFB-financed CBO sales and direct loans to guaranteed borrowers in the budget, the deficit would increase substantially. In fiscal year 1980, it would have increased from \$59.6 billion to \$73.9 billion; in 1981 it would have increased from \$57.9 billion to \$78.9 billion. These increases in the deficit do not represent new or additional federal activities; they merely acknowledge in the deficit total the federal activities already taking place. H.R. 2566 would improve the comprehensiveness of the budget deficit, but it would not completely improve the allocation process. FFB's activities would be recorded in a separate FFB budget, not in the originating agencies' budgets. Thus, there would still be an advantage to using the FFB: agencies could make their own budgets look smaller.

Focusing on the Transactions, Not on the FFB

Using the Credit Budget. The Congress could expand the credit budget concept used in the concurrent budget resolutions for fiscal years 1981 and 1982 to include separate limitations, by agency and program, on the amounts of CBOs that could be sold to the FFB or of direct loans to guaranteed borrowers that the FFB could originate. This alternative, however, totally avoids the outlay impact, and leaves the unified budget understated by the

amount of the FFB's activity. It does improve the process of allocating resources by placing limitations at the point of initiation--the agencies, not the FFB. To the extent that FFB-financed activities are viewed as being less costly because they have no unified budget impact, the potential would remain for overallocation of resources to FFB-financed activities.

Changing the Budgetary Treatment of CBO Sales and Direct Loans to Guaranteed Borrowers. If the Congress treated the sales of CBOs as borrowing--which is consistent with established budgetary principles--the funds from the sales would not be treated as off-setting receipts; therefore, by selling a CBO an agency would not be able to reduce its outlays. Agencies could sell as many CBOs to the FFB as they wished; however, the new loans represented by the CBOs would continue to be recorded as outlays in the agencies' budgets.

The Congress could also choose to change the budgetary treatment of FFB direct loans to guaranteed borrowers. These could be redefined as direct loans by the guarantor agencies and borrowing by the agencies from the FFB. Instead of the agencies recording a loan guarantee and the FFB recording budget authority and outlays, this alternative would record the budget authority and outlays in the agencies' budgets, and treat the agency-FFB transaction as borrowing, which would not affect the agencies' budget totals.

Making these changes in the budgetary treatment of agency transactions with the FFB would satisfy all three criteria outlined above. The deficit would not be understated by FFB activity; the budget would be inclusive of most activities; and agencies would be charged for the activities they initiated. Agencies could continue to finance their credit instruments at Treasury rates; they simply would not receive any budgetary advantage by doing so.

The effect of making these changes in budgetary treatment on the budget deficit would be the same as the proposal to put the FFB on-budget: increasing the budget deficit by as much as \$14 to \$20 billion. In this alternative, however, agency budgets would also increase by the amount of their FFB-financed CBO sales or direct loans to guaranteed borrowers.

Restructuring the Unified and Credit Budgets

The foregoing alternatives would make changes to the FFB or the budgetary treatment of financing transactions within the

existing framework of the unified budget. An entirely different approach would be to address the issues raised by the FFB and its activities as part of a general restructuring of the unified and credit budgets.

The unified budget includes direct lending on a net basis, but it does not include off-budget lending or loan guarantees. The experimental credit budgets for fiscal years 1981 and 1982 set targets for gross new direct loan obligations, both on- and off-budget, and for gross new loan guarantee commitments. By excluding net lending from the unified budget and adding to the credit budget a "deficit" constituted by net direct lending (on- and off-budget) and net new loans guaranteed, the status of the credit budget could be enhanced. At the same time, the advantage of using the FFB as a means of financing direct loans off-budget would be nullified. Direct lending would not be included in the reconstructed unified budget deficit, but it would be included in a credit budget deficit. Whether or not a loan was financed by the FFB would be inconsequential; in either case, it would be included in the credit budget deficit. The total of the unified budget and the credit budget deficits would be a measure of the volume of federal activities financed through the nation's credit markets in any given fiscal year. Establishing these two deficits--one for lending and one for spending--would not create additional federal activities, but would simply recognize explicitly those existing activities that must be considered in any determination of the federal government's effect on the credit markets.

Conclusion

The last of these approaches--restructuring the unified and credit budgets--is the most comprehensive and ambitious. It would result in a new dual budgetary system for the allocation of resources. It would enhance the visibility of the credit budget deficit, which now receives little or no attention relative to the unified budget deficit.

Of the four alternatives that operate within the framework of the unified budget, the two that focus on the transactions themselves are clearly superior to those that focus solely on the FFB. Of the two transaction alternatives, changing the budgetary treatment of CBO sales and FFB direct loans to guaranteed borrowers is preferable. Its sizable impact on the unified budget deficit, however, might make it unpalatable to any Congress or Administration unless it were phased in, perhaps by setting a date for

implementation in a future fiscal year. Until then, limiting the annual volume of transactions with the FFB through the credit budget could be an intermediate step that would assist the Congress in addressing the resource allocation effects of the FFB's activity without forcing it to absorb the large outlay effects immediately. This option could also be used as an intermediate step if it were decided to establish a budget concepts commission to consider the restructuring of the unified and credit budgets.

The Federal Financing Bank (FFB) was established in 1974 as an agency within the Treasury Department to coordinate the issuance or guarantee by federal agencies of marketable federal securities. These include debt issued by federal agencies, loans and loan instruments sold by agencies, and securities issued by nonfederal borrowers but guaranteed by federal agencies. The number of such financial instruments sold in the government securities market increased dramatically in the 1960s and early 1970s; by coordinating the issuance of these securities, the FFB was intended to lower the borrowing costs for the participants.

As a debt management tool, the FFB has been a success: federal agencies and guaranteed borrowers have saved millions of dollars in interest costs each year. FFB purchases of loan instruments sold by agencies and of guaranteed securities cause total budget outlays, and thus the deficit, to be understated, however. This presents two problems. First, the utility of the unified budget deficit is undermined as an indicator of the borrowing that is necessary to finance the federal government's activities. Second, the absence of effective limits on the annual volume of FFB financing poses the potential for misallocation of resources.

Various proposals have been advanced in recent years to remedy the problems posed by the FFB and its activities. In some cases, the proposals address the FFB itself; these include abolishing the FFB or setting an annual limitation on its total activity. Other proposals address the underlying issue--the budgetary treatment of credit activities financed through the FFB. These proposals include changing the budgetary treatment of loan asset sales to the FFB and of FFB direct loans to guaranteed borrowers, or setting annual limitations by program on the amounts of such transactions.

This paper reviews the establishment of the FFB, its operations, the resulting problems, and the proposals to remedy the situation. Chapter II describes why the FFB was established and what it does. Chapter III discusses the budgetary treatment of the FFB's activities. Chapter IV describes the problems that result

from FFB-financed activity and delineates the extent to which these result from the existence of the FFB itself and the extent to which they result from factors other than the FFB. The final chapter presents some proposed solutions to these problems and evaluates those proposals according to various criteria.